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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1940

No. 627

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

WILLIAM FLACCUS OAK LEATHER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR CERTIORARI FILED DECEMBER 18, 1940
CERTIORARI GRANTED FEBRUARY 10, 1941

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1 Before United States Board of Tax Appeals

Docket No. 96187

WILLIAM FLACCUS OAK LEATHER COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket entries

Appearances: For Petitioner: W. T. Royston, C. P. A., John A. McCann, Esq. For Respondent: Orris Bennett, Esq.

1938

Nov. 18—Petition received and filed. Taxpayer notified. (Fee paid.)

Nov. 18—Copy of petition served on General Counsel.

Dec. 3—Answer filed by General Counsel.

Dec. 3—Request for Circuit hearing in Pittsburgh, Pa., filed by General Counsel.

Dec. 17—Notice issued placing proceeding on Pittsburgh, Pa. Calendar. Answer and request served.

1939

Aug. 22—Hearing set Sept. 11, 1939, in Pittsburgh, Pa.

Sept. 11—Hearing had before Mr. Smith on merits. Stipulation of facts filed. Petitioner's brief due 11/1/39—Commissioner's brief due 12/1/39—Petitioner's reply due 12/15/39.

Sept. 22—Transcript of hearing of Sept. 11, 1939, filed.

Oct. 30—Brief filed by taxpayer. 10/30/39 copy served on General Counsel.

Dec. 1—Brief filed by General Counsel.

1940

Jan. 10—Memorandum opinion rendered—Charles P. Smith, Division 5. Decision will be entered for the respondent.

Jan. 10—Decision entered—Charles P. Smith, Division 5.

Apr. 8—Petitioner for review by U. S. Circuit Court of Appeals, Third Circuit, filed by taxpayer.

Apr. 8—Proof of service filed.

Apr. 12—Concise statement of points filed by taxpayer—proof of service thereon.

Apr. 12—Stipulation as to the contents of record filed.

2 Before United States Board of Tax Appeals

[File endorsement omitted]
[Title omitted.]

Petition

Filed Nov. 18, 1938

The above-named petitioner petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:B:7:8–ECE:90D) dated October 1, 1938, and as a basis of its proceeding alleges as follows:

1. The petitioner is a Pennsylvania corporation, with its principal office and place of business at 1228 River Avenue, N. S., Pittsburgh, Pennsylvania.

2. The notice of deficiency (a copy of which is attached hereto and marked "Exhibit A") was mailed to the petitioner on October 1, 1938.

3 3. The taxes in controversy are income and excess-profits taxes for the calendar year 1935, in the respective amounts of $10,055.72 and $3,656.63, respectively. For that year, petitioner filed its income and excess-profits tax return with the Collector of Internal Revenue for the Twenty-third Collection District of Pennsylvania, at Pittsburgh, Pennsylvania.

4. The determination of taxes set forth in said notice of deficiency is based on the following errors:

(a) Respondent erroneously included in income of petitioner for 1935 the sum of, to wit, $73,132.50, received by petitioner during 1935 as insurance compensation for loss sustained by petitioner in 1935 through the destruction, in that year, of business assets of petitioner having a then value of not less than $73,132.50; whereas said sum did not constitute income to petitioner in 1935 through the destruction, in that year, of business Constitution of the United States.

(b) In the alternative to the error set forth in subparagraph 4 (a) hereof, respondent erroneously (inter alia, by error in classification) included said sum of, to wit, $73,132.50 (derived as aforesaid) in ordinary income of petitioner instead of including it in capital gain and offsetting against said capital gain petitioner's 1935 capital losses in the sum of to wit, $73,222.38.

4 (c) In the alternative to the errors set forth in subparagraphs 4 (a) and 4 (b) hereof, respectively, respondent erroneously limited to $2,000 the deduction allowable to peti-

tioner for 1935 on account of losses sustained in 1935 in the sale and/or exchange by petitioner of assets (consisting of various securities issued by other corporations and not part of the inventory of petitioner or held by it as investments and not primarily for sale to its customers); whereas said limitation has no application to petitioner, a corporation.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a-1) On or about September 25, 1935, one of petitioner's plants, commonly known and designated as the Buckhannon Tannery, located at Buckhannon, West Virginia, and machinery, merchandise, and equipment therein were destroyed by fire. Said plant and other assets had a then fair market value, and had cost petitioner the sum of, not less than, $73,132.50. Said plant and other assets had a then sound value of not less than $73,132.50. Petitioner sustained an actual loss of not less
5 than $73,132.50 by reason of said fire (without regard to insurance).

(a-2) Petitioner received, in 1935, a full settlement of insurance carried by it on said assets, and in compensation for said loss, the sum of, to wit, $73,132.50.

(a-3) Said sum of, to wit, $73,132.50, received as aforesaid, did not constitute income to petitioner within the meaning of the Sixteenth Amendment to the Constitution of the United States. Said sum was merely compensatory and in an amount not exceeding petitioner's actual loss sustained in said fire.

(b-1) During and for the year 1935, petitioner had and sustained capital losses, in the sum of not less than $73,222.38.

(b-2) The amount received by petitioner as insurance compensation for said fire loss in said year was, to wit, $73,132.50.

(b-3) Respondent treated the whole of said sum of $73,132.50 (compensation) as ordinary income of petitioner and limited the deduction allowable to petitioner by reason of said capital losses of $73,222.50 to $2,000. Said $73,132.50, if it constituted income
6 at all, was capital gain of petitioner received in 1935 and should have been offset by said capital losses.

(c-1) Respondent limited said capital losses, in the amount of, to wit, $73,222.38 to $2,000, purporting to act within the purview of Section 117 (d) of the Revenue Act of 1936. Said limitation of $2,000 does not apply to petitioner, an ordinary business corporation. Petitioner is not a bank or a trust company.

Wherefore, the petitioner prays:

(1) That this Board may hear the proceeding and find and adjudicate:

(a) Said insurance compensation for fire loss—received by petitioner—did not constitute income to petitioner within the meaning of the Sixteenth Amendment to the Constitution of the United States.

(b) In the alternative, said insurance compensation, if it constituted income, consisted of capital gain, against which should be offset capital losses.

(c) The $2,000 limitation on capital net losses, contained in Section 117 (d) of the Revenue Act of 1934 does not apply to petitioner, which is a corporation but not a bank or trust company.

7 (d) That there is no deficiency in income tax or in excess-profits tax for the calendar year 1935.

(2) That this Board may grant the petitioner such other and further relief as in the premises it may deem proper; and that, in case an overpayment of taxes has been made this Board may so find and determine and may further determine as part of its decision the portion thereof paid within three years before the filing of this petition.

W. T. ROYSTON,
JOHN A. MCCANN,
Counsel for Petitioner.

JOHN A. MCCANN,
535 Union Trust Building,
Pittsburgh, Pennsylvania, and

W. T. ROYSTON,
2020 Farmers Bank Building,
Pittsburgh, Pennsylvania,
Counsel for Petitioner.

8 [*Duly sworn to by Edward H. Flaccus; jurat omitted in printing.*]

9 *Exhibit A to petition*

OFFICE OF COMMISSIONER OF INTERNAL REVENUE

Address Reply to Commissioner of Internal Revenue and Refer to IT:P:7:8-ECE:90D

TREASURY DEPARTMENT, *Washington, Oct. 19, 1938.*

WILLIAM FLACCUS OAK LEATHER COMPANY,
1228 River Avenue, N. S., Pittsburgh, Pennsylvania.

SIRS: You are advised that the determination of your income tax liability for the taxable year(x) ended December 31, 1935,

discloses a deficiency of $10,055.72 and that the determination of your excess-profits tax liability for the year(x) mentioned discloses a deficiency of $3,656.63 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C1:P-7. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner,
By (Signed) JOHN R. KIRK,
Deputy Commissioner.

Enclosures:
Statement.
Form of Waiver.
ECE/ABF.

10 STATEMENT

IT:B:7:8
ECE:90D

William Flaccus Oak Leather Company
1228 River Avenue, N. S., Pittsburgh, Pennsylvania

TAX LIABILITY FOR TAXABLE YEAR ENDED DECEMBER 31, 1935

	Liability	Assessed	Deficiency
Income tax	$21,062.01	$11,006.29	$10,055.72
Excess-profits tax	3,714.19	57.56	3,656.63
Total	24,776.20	11,063.85	13,712.35

In making this determination of your income and excess-profits tax liability, careful consideration has been given to the internal revenue agent's report dated March 24, 1937; to your protest dated May 24, 1937; and to the statements made at the conferences held on July 1, 1937, and January 14, 1938, respectively.

Your contention that the proceeds of the fire-insurance policy should be treated as capital gain subject to the provisions of section 117 of the Revenue Act of 1934 is denied. It is held that the loss of the property through the fire and the receipt of the insurance money was not a sale or exchange or capital assets as it would have to be to come within the provisions of section 117.

A copy of this letter and enclosures has been mailed to your representative Mr. W. T. Royston, in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau.

Adjustments to Net Income

Net income as disclosed by return	$80,191.20
(a) Proceeds of fire insurance	73,132.50
Net income adjusted	153,323.70

ECE/ABF-3

11 William Flaccus Oak Leather Company—Statement

Explanation of Changes

(a) Proceeds of fire insurance, $73,132.50.

The amount of $73,132.50 representing the proceeds of an insurance policy received by you for damages resulting from a fire which destroyed certain buildings and machinery has been included in your gross income in its entirety, since the cost of the buildings and machinery was recovered through depreciation allowance prior to the taxable year.

Your contention that the proceeds of the fire-insurance policy should be treated as capital gain subject to the provisions of section 117 of the Revenue Act of 1934 is denied as it is held that the loss of the property through fire and the receipt of the insurance proceeds in compensation thereof was not a sale or exchange of capital assets as it would have to be to come within the provisions of section 117.

COMPUTATION OF TAX

Income Tax

Net income for taxable year	$153,323.70
Income tax at 13¾ percent	21,082.01
Corrected income-tax liability	21,082.01
Income tax assessed: Original, account #401224	11,026.29
Deficiency in income tax	10,055.72

Net income for excess-profits tax computation	153,323.70
Less: 12½ percent of $632,320.00 value of capital stock as declared in your capital-stock tax return for year ended June 30, 1935	79,040.00
Amount subject to excess-profits tax	74,283.70
Excess-profits tax 5 percent of $74,283.70	3,714.19
Excess-profits tax assessed: Original, account #401224	57.56
Deficiency in excess-profits tax	3,656.63

ECE/ABF-3

12 Before United States Board of Tax Appeals

[File endorsement omitted.]

[Title omitted.]

Answer

Filed Dec. 3, 1938

Comes now the respondent, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein, admits and denied as follows:

1. Admits the allegations in paragraph 1 of the petition.

2. Admits that a notice of deficiency was mailed to the petitioner but alleges that it was dated and mailed on October 19, 1938.

3. Admits the allegations in paragraph 3 of the petition.

4. Denies that the Commissioner's determination is based upon errors as alleged in subparagraphs (a), (b), and (c) of paragraph 4.

5 (a–1) to (c–1), inclusive. Denies the allegations of fact contained in subparagraphs (a–1) to (c–1), inclusive, of paragraph 5 of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinabove admitted, qualified, or denied.

Wherefore, it is prayed that petitioner's appeal be denied.

(Signed) J. P. WENCHEL,
G. W. K.
J. P. Wenchel,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
HENRY C. CLARK,
Special Attorney,
Bureau of Internal Revenue.

13 Before United States Board of Tax Appeals.

[Title omitted.]

John A. McCann, Esq., for the petitioner.
Orris Bennett, Esq., for the respondent.

Memorandum opinion

January 10, 1940

SMITH: This proceeding involves a deficiency of $10,055.72 in income tax and $3,656.63 in excess-profits tax for 1935. Petitioner alleges that the respondent erred in including in its taxable income an amount of $73,132.50 received from an insurance company as compensation for loss of its buildings, machinery, and equipment by fire. In the alternative it is alleged that the respondent erred in treating the said amount of $73,132.50 as ordinary income rather than as a capital gain. Also, in the alternative, petitioner alleges that the respondent erred in limiting to $2,000 the deduction to which it was entitled on the sale or exchange of certain securities. The facts were stipulated, and are substantially as follows:

The petitioner is a Pennsylvania corporation with its principal office and place of business in Pittsburgh, Pa. For the year 1935 the petitioner filed its income and excess-profits tax return with the Collector of Internal Revenue at Pittsburgh. Petitioner's net income as disclosed by its return was $80,191.20. The respondent determined additional net income of $73,132.50, making a net adjusted income of $153,323.70.

On or about September 25, 1935, the plant which the petitioner owned and used for productive purposes, located at Buckhannon, W. Va., was destroyed by fire. The buildings, machinery, equipment, and merchandise were all destroyed. During 1935 the petitioner received insurance in compensation for its loss of $174,898, of which $101,765.50 was for the merchandise and inventory, and $73,132.50 was for the buildings, machinery, and equipment. Prior to the taxable year 1935 the buildings, machinery, and equipment referred to above had been completely depreciated on the books and records of the petitioner for income-tax purposes.

At no time during the taxable year 1935, nor at any time thereafter, did the petitioner set up a replacement fund or expend any of the insurance proceeds referred to above in the acquisition of other property similar or related in services or use to the property destroyed or in the acquisition of control of a corporation owning such other property.

In its income and excess-profits tax return for 1935 petitioner returned the insurance proceeds as capital gain, reporting the

$73,132.50 as the amount of the capital gain on the buildings and machinery. Petitioner also reported other capital gain on sales of securities in the amount of $862.50, which transactions are not here in issue. It also reported capital losses in the amount of $76,767.62, the amount of which is not here in issue. Petitioner offset the total capital gain reported in the amount of $73,995 against its total capital loss reported of $76,767.62, thus reflecting on its return a net capital loss of $2,772.62, of which it claimed $2,000 as allowable under section 117 of the Revenue Act of 1934.

14 In his audit of the return the respondent eliminated from capital gain the amount of insurance received, as above stated, and thus found petitioner's capital loss to be $75,967.62 of which only $2,000 was allowed as a deduction under the limitation provided by section 117 (d) of the Revenue Act of 1934. Respondent thus increased the capital loss exclusion from $772.62 to $73,967.62, and increased disallowance of the capital loss in the amount of $73,195. Respondent then added the $73,132.50 of insurance received to petitioner's ordinary income.

The pertinent provisions of the statute are found in the following sections of the Revenue Act of 1934:

"SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

"(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

"(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

"SEC. 112. RECOGNITION OF GAIN OR LOSS.

"(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

"(f) *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under

regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

"SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

"(d) *Limitation on Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * *"

15 In its brief the petitioner makes no argument in support of its contention that the insurance proceeds received in 1935 on account of the loss of its buildings and machinery and equipment, which had been wholly depreciated for income-tax purposes in prior years, did not constitute taxable income within the meaning of the Sixteenth Amendment to the Constitution of the United States. The contention is without merit. The gain from the receipt of the proceeds of a fire-insurance policy is clearly within the broad definition of gross income contained in section 22 (a) of the Revenue Act of 1934. The petitioner has suggested no reason why the tax upon such gain should be held objectionable on constitutional grounds and we know of none.

In its brief petitioner directs its argument chiefly to the contention that the gains resulting to it by reason of the receipt of the insurance proceeds were capital gains within the meaning of section 117 of the Revenue Act of 1934 rather than ordinary income as determined by the respondent. This identical question was decided adversely to petitioner's contentions in Estate of George Herder et al., 36 B. T. A. 934; affirmed on this point by the Court of Appeals for the District of Columbia, 106 Fed. (2d) 153. We there held that the taxpayer's loss by fire of a rice mill was not a "sale or exchange" within the meaning of section 117 (a) of the Revenue Act of 1934 and that the gain resulting from the collection of the insurance on the property was taxable as ordinary income. The court in its opinion said:

"Petitioners very strongly urge that the taxable income growing out of the involuntary conversion of the mill, should not be, in any event, treated as ordinary income, but should be treated as a capital gain and subjected to taxation under sec. 117. They contend that the definition of 'sale or exchange' of the capital gain and loss section of the statute is widened by sec. 117 (f), * * *

"It is obvious that the proceeds of the fire-insurance policy did not result from either a sale or exchange of property. * * *" Jackson v. McIntosh, 12 F. (2d) 676, cert. den., 273 U. S. 697; Iowa v. McFarland, 110 U. S. 471; Butler v. Thompson, 92 U. S. 412; Commissioner v. Freihofer, 3 Cir., 102 F. (2d) 787; Hale v. Helvering, 66 App. D. C. 242, 85 F. (2d) 819; Herring Motor Co. v. Aetna Trust & Sav. Co., 154 N. E. 29; Hartwig v. Rushing, 183 P. 177, 93 Cr. 6; Grace v. McDowell, 120 P. 413, 60 Or. 577.

The petitioner here does not rely upon subdivision (f) of section 117, which obviously has no application to the facts in the instant case, but it calls attention to the above quoted provisions of sections 111 (c) and 112 (a) and (f) of the 1934 Act and submits that—

"In Section 111 of the 1934 Act, Congress provided that gain on sale or exchange should be 'recognized.' In Section 112, it provided that on a sale or exchange, the entire amount of the gain or loss should be recognized 'except as hereinafter provided in this section.' Then follows, in 'this section' 112, subsection 'b' to 'i,' providing, all under the classification of sales or exchanges, various instances in which the entire amount of capital gain should not be recognized. Subsection 112 (f) covers our case, under the title 'Involuntary Conversions.' * * *

16 "The mere fact that involuntary conversions are treated under Section 112, in the light of the wording of subsection 112 (a), indicates clearly that gain or loss realized in connection with such a transaction is considered by the Congress as arising from a 'sale or exchange' for the purposes of Section 112 and Section 117 of the Act."

Petitioner cites Helvering v. Chester N. Weaver Co., 305 U. S. 293, and White et al., Executors v. United States, 305 U. S. 281, in which case the Supreme Court held that a loss to a stockholder from the liquidation of a corporation is a capital net loss and not an ordinary loss. The court pointed out that in case of liquidation section 115 (c) requires the tax to be computed "upon the same basis as in case of sales of the stock." White et al., Executors v. United States, supra. Section 115 (c) is not involved in the instant case and there is nothing in the applicable sections which requires the gain derived from the payment of a fire insurance policy to be treated as a capital net gain. Section 112 (f), which the petitioner states that it relies upon, applies only where there has been a conversion—a compulsory or involuntary conversion—of the property lost into property of equal or related use. There was no such conversion in the Instant case.

We are of the opinion, as stated in the Herder case, that a loss of property by fire is not from a "sale or exchange" of such

property and that the gain or loss therefrom is not to be treated as a net capital gain or loss.

Again petitioner's brief is silent on the second alternative issue in which it contends that the limitation on capital losses does not apply to corporations. Clearly, the statute can not be so construed. It was not so construed by the Supreme Court in the Weaver case. The general heading of section 117 is "Capital Gains and Losses." Subdivision (a) provides that in the case of a taxpayer "other than a corporation" certain percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income, but subdivision (d), which provides that losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges, does not exclude corporations except certain banks and trust companies. Presumably the petitioner has abandoned this issue, since it is not argued in its brief; but in any event we hold that the respondent did not err in limiting petitioner's deduction on account of its capital net losses on the sale of securities to $2,000.

Decision will be entered for the respondent.

Entered: January 10, 1940.

17 Before United States Board of Tax Appeals, Washington

Docket No. 96187

WILLIAM FLACCUS OAK LEATHER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Decision

January 10, 1940

Pursuant to the determination of the Board, as set forth in its Memorandum Opinion, entered January 10, 1940, it is

Ordered and decided: That there is a deficiency in income tax of $10,055.72, and in excess-profits tax of $3,656.63 for the year 1935.

Enter:

(Signed) C. P. SMITH,
Member.

Entered Jan. 10, 1940.

18 Before United States Board of Tax Appeals

[File endorsement omitted.]

[Title omitted.]

Petition for review by the United States Circuit Court of Appeals for the Third Circuit

Filed April 8, 1940

To the Honorable, the Judges of the United States Circuit Court of Appeals for the Third Circuit:

I

JURISDICTION

William Flaccus Oak Leather Company, your petitioner, respectfully petitions this Honorable Court to review the decision of the United States Board of Tax Appeals entered on January 10, 1940, and finding a deficiency in income and excess profits taxes due from your petitioner for the calendar year 1935, in the respective amounts of $10,055.72 and $3,656.63.

Your petitioner is a corporation organized under the laws of the State of Pennsylvania, having its principal office and place of business at 1228 River Avenue, Pittsburgh, Pennsylvania.

19 The return of income and excess profits taxes in respect of which the aforementioned tax liability arose was filed by your petitioner with the Collector of Internal Revenue for the Twenty-third Collection District of Pennsylvania, located in the City of Pittsburgh, State of Pennsylvania, which is located within the jurisdiction of the United States Circuit Court of Appeals for the Third Circuit.

Jurisdiction in this Court to review the decision of the United States Board of Tax Appeals aforesaid is founded on Sections 1001–3 of the Revenue Act of 1926 as amended by Sections 603 of the Revenue Act of 1928, 1101 of the Revenue Act of 1932, and 519 of the Revenue Act of 1934 (Internal Revenue Code, Sections 1141 and 1142).

JOHN A. MCCANN,
John A. McCann,
Attorney for Petitioner.

20 Before United States Board of Tax Appeals

[File endorsement omitted.]
[Title omitted.]

Notice of filing petition for review

Filed April 8, 1940

To: J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

You are hereby notified that Wm. Flaccus Oak Leather Company, did, on the 8th day of April 1940, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Third Circuit, of the decision of the Board heretofore rendered in the above entitled case. Copies of the petition for review as filed is hereto attached and served upon you.

Dated this 8th day of April 1940.

B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals,

Service of copy of Petition for Review acknowledged this 8th day of April, 1940.

J. P. WENCHEL,
Counsel for Respondent.

21 Before United States Board of Tax Appeals

[File endorsement omitted.]
[Title omitted.]

Stipulation of facts

Filed Sept. 11, 1939

The parties hereto, by their respective counsel, hereby stipulate and agree that the following facts may be taken to be true:

1. Petitioner is a Pennsylvania corporation with its principal office and place of business at 1228 River Avenue, N. S., Pittsburgh, Pennsylvania.

2. The taxes in controversy in this proceeding are income and excess profits taxes of the petitioner for the calendar year 1935, in the respective amounts of $10,055.72, and $3,656.63. For that year, petitioner filed its income and excess profits tax return with the Collector of Internal Revenue, for the Twenty-third Collection District of Pennsylvania, at Pittsburgh Pennsylvania.

22 3. The net income of petitioner, as disclosed by its income and excess profits tax return for 1935, was $80,191.20.

Respondent determined additional net income in the amount of $73,132.50, making the net income, as adjusted by respondent, the amount of $153,323.70. The correctness of this adjustment is at issue.

4. On or about September 25, 1935, the plant, owned by the petitioner and used by it for productive purposes, located at Buckhannon, West Virginia, and known as the Buckhannon Plant, was destroyed by fire. Not only the building, but also machinery, equipment, and merchandise were destroyed. During 1935, petitioner received, as insurance, in compensation for its said loss, the amount of $174,898.00, of which $101,765.50 was for merchandise and inventory destroyed. The fire insurance proceeds received for the buildings, machinery, and equipment were $73,132.50.

5. Prior to the year 1935, the said buildings, machinery, and equipment had been completely depreciated on the books and records of the petitioner for income-tax purposes.

6. At no time during the taxable year 1935, nor at any time thereafter, did the petitioner set up a replacement fund or expend any of the insurance proceeds so received in the acquisition of other property similar or related in services or use to the property so destroyed or in the acquisition of control of a corporation owning such other property.

23 7. In its income and excess-profits tax return for the taxable year 1935, petitioner treated said insurance proceeds as capital gain. Respondent treated said proceeds as ordinary income.

8. Petitioner returned the $73,132.50 received as insurance on the buildings and machinery as a capital gain. Petitioner also reported other capital gain on sales of securities in the amount of $862.50, which are not here in issue. Petitioner also reported other capital losses in the amount of $76,767.62, the amount of which is also not in issue. Taxpayer offset the total capital gain reported in the above amount of $73,995.00, against its total capital loss reported of $76,767.62, and thus reflected on the return a net capital loss of $2,772.62, of which it claimed $2,000.00, as allowable under Section 117 of the Revenue Act of 1934. Respondent eliminated from capital gain the amounts received by way of insurance, as above stated, and thus found the capital loss to be $75,967.62, of which $2,000.00 was allowed by respondent as a deduction under the limitation provided by Section 117 (d) of the Revenue Act of 1934. Respondent thus increased the capital loss exclusion from $772.62 to $73,967.62, or an increased disallowance of capital loss in the amount of

$73,195.00. Respondent then added the $73,132.50 received by way of insurance to ordinary income.

JOHN A. McCANN,
Counsel for Petitioner.
J. P. WENCHEL,
A
Chief Counsel, Bureau of Internal Revenue.

24 Before United States Board of Tax Appeals

[File endorsement omitted.]

[Title omitted.]

Concise Statement of the Points Upon Which the Petitioner Intends to Rely on Petition for Review

Filed April 12, 1940

Pursuant to Rule 19 of the United States Circuit Court of Appeals for the Third Circuit and to Rule 75, of the Rules of Civil Procedure for the District Courts of the United States, made applicable to this proceeding by the above Rule 19, of the United States Circuit Court of Appeals for the Third Circuit, the petitioner states the points upon which it intends to rely on Petition for Review of the final order and determination of the Board of Tax Appeals, made and entered herein on January 10, 1940.

1. The Board erred in holding and deciding that the proceeds of petitioner's insurance claim were income at all, under the Sixteenth Amendment to the Constitution of the United States, instead of a return of capital.

25 2. The Board erred in finding, holding, and deciding that there was to be included in income of the petitioner for 1935, the sum of, to wit, $73,132.50, received by petitioner during 1935 as insurance compensation for loss sustained by petitioner in 1935 through the destruction, in that year, of business assets of petitioner having a then value of not less than $73,132.50; whereas said sum did not constitute income to petitioner within the meaning of the Sixteenth Amendment to the Constitution of the United States.

3. In the alternative to the error set forth in paragraph "2" above, the Board erred in finding, holding, and deciding that there was to be included in ordinary income of the petitioner the sum of, to wit, $73,132.50, derived as insurance proceeds, as aforesaid, instead of holding, finding, and deciding that such

insurance proceeds were to be included in capital gain and that there could be offset against such capital gain, the stipulated capital losses of, to wit, $76,767.62, thus leaving the petitioner with an allowable capital loss of $2,000.

4. The Board erred in failing and refusing to allow the petitioner to offset against its gain, if any—from the destruction of some of its capital assets and the payment to it on that account of compensating insurance—the amount of its capital losses otherwise incurred, and further failing and refusing to allow petitioner a deduction for a net capital loss, thus determined, not to exceed $2,000.

26 5. The Board erred in holding and deciding that there was any deficiency in income tax and/or excess-profits tax for the taxable year 1935.

6. The Board erred in failing to hold and decide that there was no deficiency in income tax or excess-profits tax for the taxable year 1935.

7. The Board erred in that the conclusions upon which its decision is based are without any findings of fact of evidence to support them and are contrary to the evidence in the case.

JOHN A. McCANN,
John A. McCann,
Attorney for Petitioner.

APRIL 12TH, 1940.

Service of a true copy of this Designation of Points to be Relied upon on Petition for Review acknowledged and accepted this 12th day of April A. D. 1940.

J. P. WENCHEL,
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

_____,
_____,
Attorneys for Respondent.

27 Before United States Board of Tax Appeals

[File endorsement omitted.]

[Title omitted.]

Stipulation as to Contents of Record on Petition for Review

Filed April 12, 1940

It is hereby stipulated and agreed by and between the parties hereto by their respective counsel that the following shall con-

stitute the record on petition for review to the United States Circuit Court of Appeals for the Third Circuit in this cause:

1. Docket entries of the proceedings before the Board of Tax Appeals;
2. Pleadings before the Board, including Petition (with annexed copy of deficiency letter), and Answer;
3. Memorandum findings of fact and Opinion of the Board entered January 10, 1940;
4. Decision of the Board entered January 10, 1940;
5. Petition for Review;
28 6. Stipulation of Facts filed herein.
7. Statement of Points Intended to be Relied upon.
8. This Stipulation.

JOHN A. MCCANN,
John A. McCann,
Attorney for Petitioner.

J. P. WENCHEL,
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

_____,
_____,
Attorneys for Respondent.

Dated April 12 A. D. 1940.

29 [Clerk's Certificate to foregoing transcript omitted in printing.]

30 In United States Circuit Court of Appeals for the Third Circuit

No. 7420. October Term, 1940

WILLIAM FLACCUS, OAK LEATHER COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Order Assigning Ganey, J., for Argument—Filed July 12, 1940

Appeal from the U. S. Board of Tax Appeals

And now, to wit; this 12th day of July, A. D. 1940, it is ordered that Hon. J. Cullen Ganey, District Judge for the Eastern District of Pennsylvania, be, and he is hereby assigned to sit in above case in order to make a full court.

JOHN BIGGS, JR.,
Circuit Judge.

[File endorsement omitted.]

31 In United States Circuit Court of Appeals

[Title omitted.]

Minute Entry of Argument and Submission

And afterwards, to wit, the 12th day of July 1940, come the parties aforesaid by their counsel aforesaid, and this case being called for argument sur pleadings and briefs, before the Honorable Charles Alvin Jones and Honorable Herbert F. Goodrich, Circuit Judges, and Honorable J. Cullen Ganey, District Judge, and the Court not being fully advised in the premises, takes further time for the consideration thereof,

And afterwards, to wit, on the 13th day of September 1940, come the parties aforesaid by their counsel aforesaid, and the Court, now being fully advised in the premises, renders the following decision:

32 In United States Circuit Court of Appeals

[Title omitted.]

On Petition for Review of Decision of the United States Board of Tax Appeals

Opinion

Filed September 13, 1940

Before JONES and GOODRICH, Circuit Judges, and GANEY, District Judge

GOODRICH, Circuit Judge: This case comes before the court on petition to review a decision of the United States Board of Tax Appeals in favor of the respondent, Commissioner of Internal Revenue. It presents the question whether money received as insurance for the loss by fire of capital assets is to be treated as ordinary gain or capital gain to the extent that those funds are not reinvested in property similar to that destroyed.

Upon the destruction in 1935 of its plant by fire petitioner received as insurance for the loss of buildings, machinery,
33 and equipment $73,132.50. The taxpayer did not expend any of this money to replace the destroyed property, and since the latter had been entirely depreciated for income-tax purposes prior to the fire, the total amount was taxable gain to the petitioner. The sole issue is whether the gain is to be treated as ordinary income or as capital gain. The petitioner treated it

as capital gain and set it off, together with other capital gain not here in issue, against capital losses in the year 1935. The Commissioner, determining that the insurance proceeds were ordinary income, disallowed the offset. The Commissioner then added the insurance proceeds to ordinary income, and was sustained by the Board of Tax Appeals.

The Revenue Act of 1934, § 117 (d), provides that "Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges." The point at issue here is whether the gain from the receipt of the insurance money was realized from a sale or exchange.

It is good sense and good law that as a general proposition the term "sale or exchange," like other words in a revenue act, is to be accorded its ordinary meaning and is not to be tortured into strained construction. Thus this court held that the redemption of notes by the obligor did not constitute a sale or exchange of the notes by the holder, and the profit realized was ordinary as distinguished from capital gain, Felin v. Kyle, 102 F. (2d) 349 (1939); and this view was confirmed by the Supreme Court in Fairbanks v. United States, 306 U. S. 436 (1939).[1] In Hale v. Helvering, 85 F. (2d) 819 (Ct. App., D. C. 1936), it was held that the compromise of promissory notes for less than their face value when the maker was able to pay in full was not a sale or exchange of capital assets.[2] In Burnet v. Harmel, 287
34 U. S. 103 (1932) it was held that amounts received by the owner of land from oil and gas leases were not "gain from the sale or exchange of capital assets", notwithstanding the fact that under the applicable state law the leases operated to pass title to the oil and gas immediately upon execution.[3]

The latest pronouncements of this court on the subject are Commissioner of Int. Rev. v. Freihofer, 102 F. (2d) 787 (1939) and Polin v. Commissioner of Int. Rev., decided August 12, 1940. In the Freihofer case it was held that a loss resulting to the owner of land from the foreclosure of a mortgage lien thereon was an ordinary as distinguished from a capital loss. In that case this court took the position that only sales voluntarily made by a taxpayer are included in § 117 of the Act of 1934. The same result was reached by the Sixth Circuit in Commissioner of Int. Rev. v. Hammel, 108 F. (2d) 753 (1940). The Second Circuit reached a contrary conclusion in Commissioner of Int. Rev. v. Electro-Chemical Engraving Co., 110 F. (2d) 614 (1940).[4] In

[1] The Felin case was decided under the Revenue Act of 1932, and the Fairbanks case under the Revenue Acts of 1926 and 1928. The Revenue Act of 1934 specifically provides that amounts received upon the retirement of notes, bonds, etc., shall be treated as having been "received in exchange therefor." § 117 (f).
[2] Under the Revenue Act of 1928.
[3] Under the Revenue Act of 1924.
[4] Cert. grant. June 3, 1940.

the Polin case it was held that the abandonment and surrender without consideration of mortgaged property by the mortgagor was not a sale or exchange.

It is clear that a realization of loss or gain by the receipt of insurance after the destruction of property is not a sale or exchange in the usual sense of those words, and it is equally clear that the usual sense ordinarily governs. But of course the Congress may provide that a particular transaction which ordinarily would fall outside of the scope of the meaning of "sale or exchange," may be treated as though it were a sale or exchange. Thus § 117 (f) of the 1934 Act provides that amounts received upon the retirement of "bonds, debentures, notes, or certificates or other evidences of indebtedness . . . shall be considered as amounts received in exchange therefor." It is argued, and we think soundly, that the Congress has so provided with respect to the transaction here in question.

35 Section 112 of the Act of 1934 provides, inter alia:

"(a) General Rule.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

(f) Involuntary Conversions.—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

It will be noted that subsection (f) is an exception to subsection (a) which states the general rule with respect to a sale or exchange. This would seem to indicate that the Congress chose to classify, for tax purposes, the involuntary conversion of property by destruction (and other named involuntary methods) as a sale or exchange of that property. No reason is suggested why the term "sale or exchange" should have any different meaning in § 117 than in § 112. This conclusion is further fortified when it is noted that in § 111 (a) and (b) Congress speaks of the gain from the sale or other disposition of property, whereas

in § 111 (c) in providing that § 112 should govern the
36 recognition of gain or loss, it speaks of a sale or exchange.

We hold, therefore, that the gain realized upon the receipt of insurance for the destruction of capital assets is a capital gain within the meaning of § 117(f).

The conclusion here reached is contrary to that reached in Herder v. Helvering, 106 F. (2d) 153 (Ct. App., D. C. 1939).[5] It does not appear from the opinion that the ground upon which we rest our decision was presented to that court. It seems that it was there argued that the insurance proceeds came within the terms of § 117(f) as amounts received ". . . upon the retirement of bonds, debentures, notes or certificates or other evidences of indebtedness . . ."

The decision of the Board of Tax Appeals is therefore reversed.

37 In United States Circuit Court of Appeals

WILLIAM FLACCUS OAK LEATHER COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Judgment—Filed Sept. 13, 1940

Appeal from the United States Board of Tax Appeals

This cause came on to be heard on the transcript of record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged, and decreed by this Court that the decision of the said Board of Tax Appeals in this cause be, and the same is hereby reversed.

Philadelphia, September 13, 1940.

HERBERT F. GOODRICH,
Circuit Judge.

[File endorsement omitted.]

38 [Clerk's Certificate to foregoing transcript omitted in printing.

39 [Stipulation in re record omitted in printing.]

[5] Cert. den. 308 U. S. 617 (1939).

40 Supreme Court of the United States

Order allowing certiorari

Filed February 10, 1941

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Third Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[Endorsement on cover:] File No. 44, 976. U. S. Circuit Court of Appeals, Third Circuit. Term No. 627. Guy T. Helvering, Commissioner of Internal Revenue, petitioner, vs. William Flaccus Oak Leather Company. Petition for a writ of certiorari and exhibit thereto. Filed December 13, 1940. Term No. 627 O. T. 1940.

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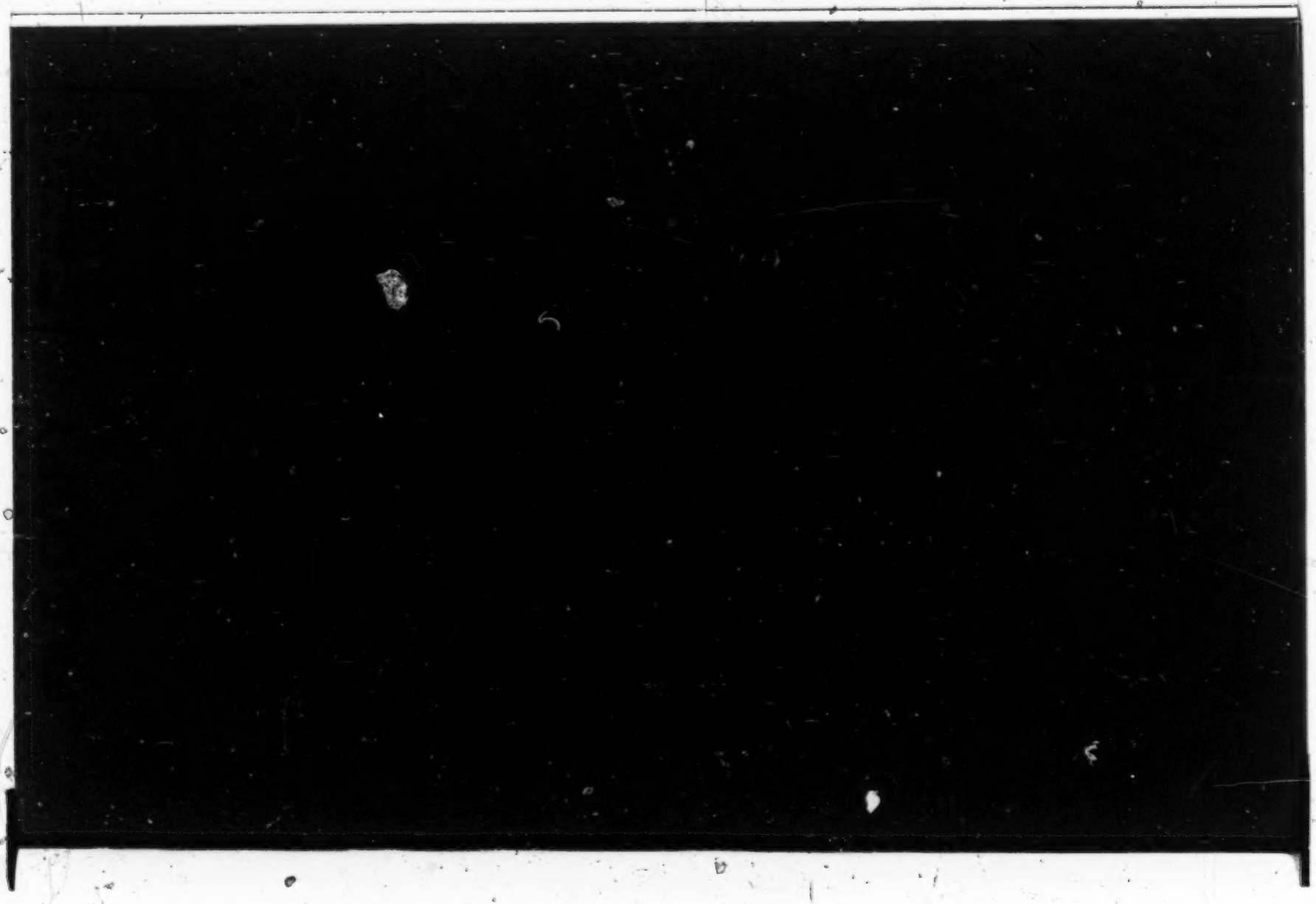

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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 627

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WILLIAM FLACCUS OAK LEATHER COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Third Circuit entered in the above-entitled cause on September 13, 1940.

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 5) is unreported. The opinion of the Circuit Court of Appeals (R. 17) is reported in 114 F. (2d) 783.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered September 13, 1940 (R. 23). The

jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the gain arising from insurance payments for loss by fire of certain property, owned by the taxpayer, is a gain from the "sale or exchange" of a capital asset which may enter into the computation, under Section 117 (d) of the Revenue Act of 1934, of the deduction allowable for losses sustained by the taxpayer from sales or exchanges of other capital assets.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 7–11.

STATEMENT

The pertinent facts, found by the Board of Tax Appeals (R. 6) to be as stipulated (R. 3–5), may be summarized as follows:

On or about September 25, 1935, a plant owned by the taxpayer at Buckhannon, West Virginia, was destroyed by fire. The buildings, machinery, equipment, and merchandise were all destroyed. During the taxable year 1935, the taxpayer received, as insurance compensation for its loss, the amount of $174,898, of which $101,765.50 was for merchandise and inventory destroyed and $73,132.50 for the buildings, machinery, and equipment.

Prior to the taxable year 1935, the buildings, machinery, and equipment had been completely depreciated on the books and records of the taxpayer for income-tax purposes. (R. 4.)

At no time during the taxable year 1935, nor at any time thereafter, did the taxpayer set up a replacement fund or expend any of the insurance proceeds so received in the acquisition of other property similar or related in services or use to the property as destroyed or in the acquisition of control of a corporation owning such other property. (R. 4.)

The taxpayer returned the $73,132.50, received as insurance on the buildings and machinery, as a capital gain for the year 1935. It reported other capital gain, on sales of securities, in the amount of $862.50, which is not here in issue, and capital losses in the amount of $76,767.62, likewise not in issue. Against its total capital loss reported of $76,767.62, it offset its total capital gain reported in the amount of $73,995, and thus reflected on its return a net capital loss of $2,772.62, of which it claimed $2,000 as allowable under Section 117 of the Revenue Act of 1934. (R. 5.)

The Commissioner eliminated from capital gain the amounts received by way of insurance on the ground that these amounts were ordinary income. He thus found the capital loss to be $75,967.62, of which $2,000 was allowed as a deduction, under the limitation provided by Section 117 (d) of the Reve-

nue Act of 1934, and increased the capital loss exclusion from $772.62 to $73,967.62 or an increased disallowance of capital loss in the amount of $73,195. The Commissioner then added the $73,132.50 received by way of insurance to ordinary income. (R. 5.)

The Board of Tax Appeals approved the determination of the Commissioner (R. 5–12). On appeal, to the Circuit Court of Appeals for the Third Circuit, the Board's decision was reversed (R. 17–21).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the gain arising from insurance payments for loss by fire of certain property, owned by the taxpayer, is a gain from the "sale or exchange" of a capital asset which may enter into the computation, under Section 117 (d) of the Revenue Act of 1934, of the deduction allowable for losses sustained by the taxpayer from sales or exchanges of other capital assets.

2. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The decision below is in direct conflict with *Herder* v. *Helvering*, 106 F. (2d) 153 (App. D. C.), certiorari denied, 308 U. S. 617, rehearing denied, 308 U. S. 639. The opinion of the court below recognizes this conflict.

2. A related question is pending before this Court in *Helvering* v. *Hammel*, No. 49, and *Electro-*

Chemical Engraving Co., Inc. v. *Commissioner*, No. 62, October Term, 1940, in which cases the Government takes the position that the loss suffered from foreclosure sales is a loss from the "sale" of a capital asset.

3. The court below in *Commissioner* v. *Freihofer*, 102 F. (2d) 787, contrary to the position taken by the Government in the *Hammel* and *Electro-Chemical* cases, held that a loss resulting to the owner of land from the foreclosure of a mortgage lien was *not* a loss from a "sale or exchange" within the meaning of Section 117 of the Revenue Act of 1934, *infra*, p. 9. But in the present case, it held that Congress, in Section 112 of the Revenue Act of 1934, *infra*, p. 8, classified the involuntary conversion of property by destruction, together with other named involuntary methods of conversion, as a sale or exchange of property, and that the term "sale or exchange" should have the same meaning in Section 117 and in Section 112. Obviously, much confusion is likely to result as a consequence of the decision below. And since the question whether destruction of property, or theft or seizure of property, is a sale or exchange of such property, within the meaning of the capital gain and loss section of the Revenue Acts, is likely to recur frequently, it would be helpful in the administration of the revenue laws to have the issue clarified.

CONCLUSION

It is respectfully submitted that, for the foregoing reasons, this petition should be granted.

FRANCIS BIDDLE,
Solicitor General.

DECEMBER, 1940.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23. [U. S. C., Title 26, Sec. 21.]

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes * * * gains or profits and income derived from any source whatever. * * *

* * * * * *

(e) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111. [U. S. C., Title 26, Sec. 22.]

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * * *

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * * *

[U. S. C., Title 26, Sec. 111.]

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

(1) *Property Held for Productive Use or Investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

(2) *Stock for Stock of Same Corporation.*—* * *

(3) *Stock for Stock on Reorganization.*—* * *

(4) *Same—Gain of Corporation.*—* * *

(5) *Transfer to Corporation Controlled by Transferor.*—* * *

(c) *Gain From Exchanges Not Solely in Kind.*—

* * * * * *

(d) *Same—Gain of Corporation.*—* * *

* * * * * *

(e) *Loss From Exchanges Not Solely in Kind.*—* * *

(f) *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or in the threat or imminence thereof) is com-

pulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

* * * * * *

[U. S. C., Title 26, Sec. 112.]

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *General Rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

* * * * * *

(b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * * *

(d) *Limitation on Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges.

* * * * *

(f) *Retirement of Bonds, etc.*—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor. [U. S. C., Title 26, Sec. 101.]

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 117–1. *Meaning of capital assets.*—The term "capital assets" includes all classes of property not specifically excluded by section 117 (b). The term is not limited to stocks and bonds nor to property held for more than two years. In determining whether property is a "capital asset," the period for which held is immaterial.

ART. 117–2. *Limitations on capital gains and capital losses.*— * * *

Section 117 (d) provides a limitation on deductions for capital losses affecting all taxpayers including corporations, that is, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of $2,000 plus the gains from such sales and exchanges. However, in the case of certain banks or trust companies, this

limitation is subject to the modification provided in that section.

* * * * * *

ART. 117–4. *Application of section 117 generally.*—Section 117 applies only to gains and losses upon the sale or exchange of capital assets and, therefore, has no application to loss of useful value upon the permanent abandonment of the use of property (see article 23 (e)–3), or loss sustained as the result of corporate stock or debts becoming worthless.

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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 627

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WILLIAM FLACCUS OAK LEATHER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 8) is unreported. The opinion of the Circuit Court of Appeals (R. 19) is reported in 114 F. (2d) 783.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered September 13, 1940. (R. 22.) The petition for a writ of certiorari was filed December 13, 1940, and was granted February 10, 1941. The

jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer received insurance payments on account of property which had been destroyed by fire. The question presented is whether the resulting profit is ordinary income or capital gain. The answer to this question depends upon whether the destruction of and payment for the property constituted a "sale or exchange" within the meaning of Section 117 (d) of the Revenue Act of 1934.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 22–31.

STATEMENT

The pertinent facts, found by the Board of Tax Appeals (R. 8) to be as stipulated (R. 14–16), may be summarized as follows:

On or about September 25, 1935, a plant owned by the taxpayer at Buckhannon, West Virginia, was destroyed by fire. The buildings, machinery, equipment, and merchandise were all destroyed. During the taxable year 1935, the taxpayer received, as insurance compensation for its loss, the amount of $174,898, of which $101,765.50 was for merchandise and inventory destroyed and $73,-

132.50 for the buildings, machinery, and equipment. Prior to the taxable year 1935, the buildings, machinery, and equipment had been completely depreciated on the books and records of the taxpayer for income-tax purposes. (R. 8.)

At no time during the taxable year 1935, nor at any time thereafter, did the taxpayer set up a replacement fund or expend any of the insurance proceeds so received in the acquisition of other property similar or related in services or use to the property destroyed or in the acquisition of control of a corporation owning such other property. (R. 8.)

The taxpayer returned the $73,132.50 insurance proceeds as a capital gain for the year 1935. It reported other capital gain, on sales of securities, in the amount of $862.50, which is not here in issue, and capital losses in the amount of $76,767.62, likewise not in issue. Against its total capital loss reported of $76,767.62, it offset its total capital gain reported in the amount of $73,995, and thus reflected on its return a net capital loss of $2,772.62, of which it claimed $2,000 as allowable under Section 117 of the Revenue Act of 1934. (R. 8–9.)

The Commissioner eliminated from capital gain the amounts received by way of insurance on the ground that these amounts were ordinary income. He thus found the capital loss to be $75,967.62,[1] of which $2,000 was allowed as a deduction, under the limitation provided by Section 117 (d) of t. e Rev-

[1] See footnote on p. 4.

enue Act of 1934, and increased the capital loss exclusion from $772.62 to $73,967.62[1] or an increased disallowance of capital loss in the amount of $73,195.[1] The Commissioner then added the $73,132.50 received by way of insurance to ordinary income. (R. 9.)

The Board of Tax Appeals approved the determination of the Commissioner. (R. 8–12.) On appeal to the Circuit Court of Appeals for the Third Circuit the Board's decision was reversed. (R. 19–22.)

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the gain arising from insurance payments for loss by fire of certain property, owned by the taxpayer, is a gain from the "sale or exchange" of a capital asset which may enter into the computation, under Section 117 (d) of the Revenue Act of 1934, of the deduction allowable for losses sustained by the taxpayer from sales or exchanges of other capital assets.

2. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

The taxpayer seeks to offset against losses sustained by it in the taxable year from the sale of

[1] There is apparently an error of $62.50 in these figures, which, however, does not affect the deficiencies determined by the Board.

capital assets the amount of gain which it derived from the payment by an insurance company for property destroyed by fire. The sole question presented is whether there was a "sale or exchange" of the destroyed property within the meaning of Section 117 (d) of the Revenue Act of 1934.

The words "sale" and "exchange," as used in Section 117 (d), are to be taken in their ordinary meaning, and they do not include indemnification received from an insurance company for loss of property. One does not sell or exchange that which has ceased to exist.

There is no merit to the argument that Congress has in Section 112 (f) of the Revenue Act of 1934 classified destruction of property as a sale or exchange, where, as here, the proceeds of insurance are not expended in the acquisition of similar property, nor is there any basis for an argument that there has been an administrative classification to that effect which has received the implied approval of Congress.

ARGUMENT

THE GAIN DERIVED BY THE TAXPAYER FROM THE PAYMENT BY THE INSURANCE COMPANY FOR THE DESTRUCTION OF CERTAIN PROPERTY BY FIRE WAS NOT A GAIN FROM THE "SALE OR EXCHANGE" OF SUCH PROPERTY

During the taxable year 1935, the taxpayer had losses from the sale of capital assets [2] in the amount

[2] The term "capital assets" means property held by the taxpayer, whether or not connected with his trade or business, with certain exceptions not applicable here. See Section 117 (b), Revenue Act of 1934, *infra*, p. 26.

of $76,767.62. Under Section 117 (d) of the Revenue Act of 1934, c. 277, 48 Stat. 680, *infra*, p. 27, these losses are deductible only to the extent of $2,000, plus the gains from "sales or exchanges" of capital assets.

In September, 1935, certain buildings, machinery, and equipment owned by the taxpayer were destroyed by fire, and the taxpayer received insurance in compensation for its loss of $73,132.50. Prior to the taxable year 1935, these buildings, machinery, and equipment had been completely depreciated on the books and records of the taxpayer for income-tax purposes, and consequently the entire amount of $73,132.50 constituted a profit or gain for tax purposes. The taxpayer contends that this gain was a gain from the "sale or exchange" of capital assets, and hence may be added to the specific deduction of $2,000 provided for in Section 117 (d) of the Revenue Act of 1934 in determining the deductible portion of the capital losses sustained by it in the taxable year.

The Board of Tax Appeals, following its decision in *Herder* v. *Commissioner*, 36 B. T. A. 934, affirmed on this point, 106 F. (2d) 153 (App. D. C.), certiorari denied, 308 U. S. 617, rehearing denied, 308 U. S. 639, sustained the ruling of the Commissioner that the compensation received by the taxpayer from the insurance company for the property destroyed by fire did not arise from the "sale or exchange" of the property. The court below

reversed this holding. The sole question here presented is whether there was "a sale or exchange" of the destroyed property within the meaning of Section 117 (d) of the Revenue Act of 1934.

The taxpayer conceded below and the Circuit Court of Appeals held that a realization of loss or gain by the receipt of insurance after the destruction of property is not a "sale" or "exchange" of the property in the usual sense of those words. This holding is clearly correct. A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent. *Five Per Cent. Cases,* 110 U. S. 471, 478. Thus numerous transactions have been held not to be within the meaning of the words "sale or exchange" as used in the revenue acts where they were not within the ordinary meaning of those words; for example, the redemption of bonds before maturity by the issuing corporation (*Fairbanks* v. *United States,* 306 U. S. 436; *Felin* v. *Kyle,* 102 F. (2d) 349 (C. C. A. 3d)); surrender of life insurance and annuity contracts (*Bodine* v. *Commissioner,* 103 F. (2d) 982 (C. C. A. 3d)) compromise of promissory notes (*Hale* v. *Helvering,* 85 F. (2d) 819 (App. D. C.)); oil and gas leases considered as sales under local law (*Burnet* v. *Harmel,* 287 U. S. 103). An exchange is the transfer of property for property. A payment on a fire insurance policy, on the other hand, is idemnification for the loss of the property. See *Herder* v. *Commissioner, supra; Commonwealth* v. *Wetherbee,* 105 Mass. 149, 160; *Dover Glass Wks. Co.* v.

Amer. Fire Ins. Co., 1 Marv. (Del.) 32, 45; *Brock* v. *Hardie*, 114 Fla. 670, 686; *Atlantic Steel Co.* v. *Hartford Fire Insurance Co.*, 39 Ga. App. 680.

The sole contention advanced below by the taxpayer was that Congress, in Section 112 of the Revenue Act of 1934, *infra*, p. 23, had classified, for tax purposes, the involuntary conversion of property by destruction and other named involuntary methods as a sale or exchange of the property. This contention was sustained by the court below.

Section 112 does not deal in any way with the *classification* of gain or loss; it does not undertake to say what shall be treated as capital gain or loss and what shall be treated as ordinary gain or loss. Section 112 is concerned with the *recognition* and *non-recognition* of gain or loss in corporate reorganizations and similar transactions; it provides the extent to which gain that would otherwise be taxable is to be entirely relieved of tax, and the extent to which an otherwise deductible loss is to be denied. Subdivision (a) of Section 112 states as the general rule that upon the "sale or exchange" of property the entire amount of gain or loss, determined under Section 111, shall be recognized "except as hereinafter provided in this section". There then follow a number of subdivisions dealing with corporate reorganizations and other transactions of somewhat comparable character. Among

those subdivisions is subdivision (f), which reads as follows:

> *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

It will be noted that Section 112 (f) deals with the *replacement* of property by other similar property. In such cases only the form of the investment is changed, and Congress was therefore willing to include the transaction described in Section 112 (f) in a single class with others in the remaining subdivisions of Section 112 which had the same general characteristic of change of form without change of substance. But here the prop-

erty destroyed was not replaced, and we therefore think that Section 112 (f) has no application whatever.

It is true that Section 112 (f) deals in the last sentence with "any part of the money" which is not expended for replacement. But that is clearly intended to insure that a transaction otherwise within Section 112 (f) shall not be affected by a failure to expend for replacement every dollar of the money realized. Section 112 as a whole deals with situations where property is exchanged for similar property and, unless Section 112 (f) is an exception, it does not purport to deal with dispositions of property solely for cash. Cf. *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462.

We submit that the last sentence of Section 112 (f) is applicable only where there has been a replacement in which all of the money realized was not expended. Although Congress was primarily interested in replacement, it realized that the taxpayer might receive cash and make his own replacement, and that there might be an unexpended balance of cash remaining after the replacement was made. Rather than limit the tax benefit to a transaction where the insurance company made the replacement, Congress included as well the transactions where the taxpayer collected the insurance money and made his own replacement, and rather than insist upon a replacement which would cost the identical amount realized, Congress in-

cluded the case where there was an incidental unexpended balance. To insure that these situations be covered, the last sentence was added to the section, but it was never intended, we submit, to deal with the situation where the taxpayer retained the insurance money and made no replacement. It would be pointless for Congress to require that the replacement must consist of property "similar or related in service or use", but nevertheless make the section applicable to a transaction in which there has been no replacement whatever.

If we are correct that Congress was concerned in Section 112 (f) with the *replacement* of property and not, as contended by taxpayer (Br. in Op. 3), with the "destruction of property, and its compensation", then Section 112 (f) has no application whatever to this case and taxpayer's contention that Congress made an exception applicable to this transaction necessarily fails.

However, if Section 112 (f) is applicable to a mere destruction of property and compensation therefor, the conclusion of the court below is nevertheless erroneous.

The conclusion of the court below that Congress had classified involuntary conversions of property as a sale or exchange of the property was based upon the fact that Congress had placed the provision relating to involuntary conversions in Section 112 as an exception to the general rule set forth in subdivision (a) of that section with re-

spect to a sale or exchange. The court below also stated that its conclusion was fortified by the fact that in Section 111 (a) and (b) Congress speaks of the gain from the sale or other disposition of property, whereas in Section 111 (c), in providing that Section 112 should govern the recognition of gain or loss, it speaks of a sale or exchange.[3] We submit that the decision of the court below is erroneous.

First. It will be observed that the question in the present case is the converse of that in *Helvering* v. *Hammel*, No. 49, present Term, decided January 6, 1941. In the *Hammel* case the question was whether a forced sale, which would be within the ordinary meaning of the word "sale", should be excluded from the meaning of the word as used in the revenue act because of the purpose with which the word was used in the statute and the legislative history of that use. Here the question is whether Congress has declared that a transaction which is

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[3] We believe that no importance should be attached to Section 111 (c). The provision contained in that subdivision first appeared in subdivision (d) of Section 202 of the Revenue Act of 1924. In S. Rep. No. 398, 68th Cong., 1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 266, 275), the Committee on Finance stated:

> Subdivision (d) is merely informatory, stating that the amount of the gain determined under its provisions shall be recognized as provided in section 203, which states those cases in which no gain or loss from a sale or exchange is recognized and those cases in which a limitation is placed upon the gain or loss to be recognized from the sale or exchange.

not within the ordinary meaning of sale or exchange should be treated as though it were a sale or exchange.

There admittedly is no express provision in either Section 112 or elsewhere in the revenue act that an involuntary conversion of property shall be treated as a sale or exchange of that property. It would seem clear that if Congress had intended that loss of property by fire or other casualty, which would not be considered a sale or exchange of property within the ordinary meaning of those words, should be treated as a sale or exchange, it would have declared its purpose in apt language. In all other instances where it has intended that a transaction which would not be embraced within the ordinary or usual meaning of the words sale or exchange should be treated as though it were a sale or exchange, Congress has been specific in so stating. Thus, in Section 115 (c) of the Revenue Act of 1934, it is provided that amounts distributed in complete liquidation of a corporation "shall be treated" as in full payment "in exchange for" the stock. In Section 117 (e) (1) of the Revenue Act of 1934 it is provided that gains or losses from short sales of property "shall be considered" as gains or losses from "sales or exchanges of capital assets". In Section 117 (e) (2) it is provided that gains or losses attributable to the failure to exercise privileges or options to buy or sell property "shall be considered" as gains or losses from "sales or ex-

changes of capital assets". In Section 117 (f) it is provided that amounts received by the holder upon the retirement of bonds and other evidences of indebtedness issued by any corporation with interest coupons or in registered form "shall be considered" as amounts received "in exchange" therefor. And in Section 23 (k) (2) of the Revenue Act of 1938 c. 289, 52 Stat. 447, it is provided that if any securities as defined in paragraph 3 of that subsection are ascertained to be worthless and charged off within the taxable year and are capital assets, the loss resulting therefrom shall, in the case of a taxpayer other than a bank, "be considered" as a loss from the "sale or exchange", on the last day of such taxable year, of capital assets.

Second. Subdivision (f) of Section 112 of the Revenue Act of 1934 is the outgrowth of provisions which first appeared as Sections 214 (a) (12) and 234 (a) (14) of the Revenue Act of 1921. Sections 214 (a) (12) and 234 (a) (14) contain identical language, the former of these two sections appearing under the heading "Deductions Allowed Individuals", and the latter appearing under the heading "Deductions Allowed Corporations". These sections provided that if property is compulsorily or involuntarily converted into cash or its equivalent as a result, *inter alia*, of its destruction in whole or in part, and if the taxpayer proceeds forthwith in good faith, under reg-

ulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds.[4]

In the Revenue Act of 1921, under the heading of "Basis for Determining Gain or Loss", there appeared in subdivision (c) of Section 202 provisions dealing with the non-recognition of a gain or loss upon certain exchanges of property. In subdivision (d) (1) of that section it was provided that where property is exchanged for other property and no gain or loss is recognized under the provisions of subdivision (c), the property received shall, for the purposes of that section, be treated as taking the place of the property exchanged therefor, with certain exceptions which were set forth in subdivision (e) of that section. Subdivision (d) (2) of Section 202 of the Revenue Act of

[4] See H. Rep. No. 350, 67th Cong., 1st Sess., p. 12 (1939–1 Cum. Bull. (Part 2) 168, 177); S. Rep. No. 275, 67th Cong., 1st Sess., pp. 14–15 (1939–1 Cum. Bull. (Part 2) 181, 191).

1921 contained a provision with respect to the involuntary conversion of property, as follows:

> Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in paragraph (12) of subdivision (a) of section 214 and paragraph (14) of subdivision (a) of section 234, and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein provided, the property acquired shall, for the purpose of this section, be treated as taking the place of a like proportion of the property converted.

In the Revenue Act of 1924, the provisions of the preceding Act of 1921 relating to the recognition of gain or loss were placed in a separate section (Section 203). There was included in that section under subdivision (b) (5) a provision with relation to the involuntary conversion of property which in effect constituted a combination and revision of Sections 214 (a) (12) and 234 (a) (14) of the 1921 Act.[5] This provision, contained in Section 203 (b) (5) of the Revenue Act of 1924, was carried forward in identical language in later revenue acts and appears as subdivision (f) of Section 112 of the Revenue Act of 1934.

It is thus seen that the predecessor section to

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[5] See H. Rep. No. 179, 68th Cong., 1st Sess., pp. 13–14 (1939–1 Cum. Bull. (Part 2) 241, 251); S. Rep. No. 398, 68th Cong., 1st Sess., p. 15 (1939–1 Cum. Bull. (Part 2) 266, 276).

subdivision (f) of Section 112 of the Revenue Act of 1934 took the form of a deduction from gross income under specially stated circumstances, namely, where gain was derived from the involuntary conversion of the property and the proceeds of the conversion were forthwith expended for the acquisition of other property of a similar character or in the establishment of a replacement fund. Where there was such an acquisition of similar property with the proceeds of an involuntary conversion, the newly acquired property was considered as taking the place of the old property. In these special circumstances, Congress has disregarded the receipt and expenditure of cash and has treated the transaction as though the old property were exchanged directly for the new property. In the revision and rearrangement of the statutory provisions which occurred in the Revenue Act of 1924, Congress changed the provision from the form of a deduction to one of non-recognition of gain or loss upon the transaction. Since the new statutory provision was cast in the form of non-recognition of gain or loss it was logical that it should appear in a section dealing generally with non-recognition of gain or loss. It is true that the provisions dealing with non-recognition of gain or loss are expressed as exceptions to the general rule that the entire amount of gain shall be recognized upon the sale or exchange of property. It will be noted, however, that there is no exception to the

recognition of gain or loss upon a pure sale, that is, where property is transferred for cash or its equivalent. Cf. *Pinellas Ice Co.* v. *Commissioner,* 287 U. S. 462.

The only exceptions to the recognition of gain or loss are cases where there has been a transfer of property for property. As pointed out, Congress has treated the conversion of property by fire and other involuntary methods as a transfer of property for property, i. e., an exchange, only where the cash received upon the involuntary conversion is forthwith used for the acquisition of other property similar or related in service or use to the property so converted. There is, we submit, in these statutory provisions, no indication of a congressional purpose to treat the destruction of property as a sale or exchange of that property where cash only is received and where this cash is not expended in the manner specified in the statute. Cf. *Bandes* v. *Commissioner,* 69 F. (2d) 812 (C. C. A. 2d), involving the condemnation of property, which embraces features of a sale not present in the case of destruction of property and therefore conceivably to be governed by a different rule. In the present case the taxpayer received only cash indemnification for its loss by fire and it concededly did not expend this cash for the acquisition of other property similar to the destroyed property or in the establishment of a replacement fund. Admittedly, therefore, the taxpayer is not entitled to the benefits of subdivision (f) of Section 112.

Third. In none of the Treasury Regulations promulgated under the revenue acts prior to that of 1934 has there been a classification of the gain arising from the payment for destruction of property by fire or other casualty as a gain arising from the sale or exchange of a capital asset. See Article 1600, Treasury Regulations 65 and 69; Article 601, Treasury Regulations 74 and 77. In Article 113 (a) (9) (1) of Treasury Regulations 86, promulgated under the Revenue Act of 1934, *infra*, p. 30, which deals with the basis of property acquired with the proceeds of insurance from destroyed property, there appeared for the first time the statement that "As to the amount of such gain to be taken into account in computing net income, see section 117". Section 117 is the section relating to capital gains and losses. Treasury Regulations 86 were approved on February 11, 1935. On September 23, 1936, the language which we have quoted from Article 113 (a) (9) (1) was eliminated. See T. D. 4698, XV-2 Cum. Bull. 159 (1936). There appears, therefore, to have been no consistent administrative practice classifying the destruction of property as a sale or exchange of property.

It is clear that destruction of property by fire is not a "sale or exchange" of property within the ordinary meaning of those words, and, we submit, there is no congressional classification, express or implied, of such destruction as a sale or exchange.

CONCLUSION

The decision of the court below is erroneous and should be reversed.

Respectfully submitted.

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MARCH 1941.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23. [U. S. C., Title 26, Sec. 21.]

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes * * * gains or profits and income derived from any source whatever. * * *

* * * * *

(e) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111. [U. S. C., Title 26, Sec. 22.]

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(e) LOSSES BY INDIVIDUALS.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

* * * * *

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the

time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

(f) LOSSES BY CORPORATIONS.—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(j) CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117 (d).

* * * * *

[U. S. C., Title 26, Sec. 23.]

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * *

[U. S. C., Title 26, Sec. 111.]

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

(1) *Property Held for Productive Use or Investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

(2) *Stock for Stock of Same Corporation.*— * * *

(3) *Stock for Stock on Reorganization.*— * * *

(4) *Same—Gain of Corporation.*— * * *

(5) *Transfer to Corporation Controlled by Transferor.*— * * *

(c) *Gain From Exchanges Not Solely in Kind.*—

* * * * *

(d) *Same—Gain of Corporation.*—

* * * * *

(e) *Loss From Exchanges Not Solely in Kind.*— * * *

(f) *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Com-

missioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

* * * * *

[U. S. C., Title 26, Sec. 112.]

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) BASIS (UNADJUSTED) OF PROPERTY.—The basis of property shall be the cost of such property; except that—

* * * * *

(6) TAX-FREE EXCHANGES GENERALLY.—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112 (b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received,

and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

* * * * *

(9) INVOLUNTARY CONVERSIONS. If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion described in section 112 (f), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made.

* * * * *

[U. S. C., Title 26, Sec. 113.]

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *General Rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income: * * *

(b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade

or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(c) DETERMINATION OF PERIOD FOR WHICH HELD.—* * *

(d) LIMITATION ON CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, sells any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted basis of such instrument exceeds the par or face value thereof) shall not be subject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses.

(e). GAINS AND LOSSES FROM SHORT SALES, ETC.— * * *

(f) RETIREMENT OF BONDS, ETC.—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a gov-

ernment or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor. [U. S. C., Title 26, Sec. 101.]

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 112 (f)-1. *Reinvestment of proceeds of involuntary conversion.*—In order to avail himself of the benefits of section 112 (f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. The benefits of section 112 (f) cannot be extended to a taxpayer who does not purchase other property similar or related in service or use, notwithstanding the fact that there was no other such property available for purchase.

* * * * *

It is incumbent upon a taxpayer "forthwith" to apply for and receive permission to establish a replacement fund in every case where it is not possible to replace immediately. If an expenditure in actual replacement would be too late, a request for the establishment of a replacement fund would likewise be too late.

ART. 112 (f)-2. *Replacement funds.*—In any case where the taxpayer elects to replace

or restore the converted property but it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage. In such a case the taxpayer should make application to the Commissioner on Form 1114 for permission to establish such a replacement fund, and in his application should recite all the facts relating to the transaction and declare that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require in an amount not in excess of double the estimated additional income taxes which would be payable if no replacement fund were established. See section 1126 of the Revenue Act of 1926 (paragraph 31 of the Appendix to these regulations), providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. The estimated additional taxes, for the amount of which the applicant is required to furnish security, should be computed at the rates at which the applicant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant, and

the surety or depasitory may each have a copy.

ART. 113 (a) (9)–1. *Property acquired as a result of an involuntary conversion.*—The provisions of section 113 (a) (9) may be illustrated by the following example:

Example: A vessel purchased by A in 1926 for $100,000 is destroyed in 1934 and A receives insurance in the amount of $200,000. Disregarding, for the purpose of this example, the adjustment for depreciation, if A invests $150,000 in a new vessel, taxable gain to the extent of $50,000 would be recognized. As to the amount of such gain to be taken into account in computing net income, see section 117. The basis of the new vessel is $100,000; that is, the cost of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000).

ART. 117–1. *Meaning of capital assets.*—The term "capital assets" includes all classes of property not specifically excluded by section 117 (b). The term is not limited to stocks and bonds nor to property held for more than two years. In determining whether property is a "capital asset," the period for which held is immaterial.

ART. 117–2. *Limitations on capital gains and capital losses.*—* * *

Section 117 (d) provides a limitation on deductions for capital losses affecting all taxpayers including corporations, that is, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of $2,000 plus the gains from such sales and exchanges. However, in the case of certain banks or trust companies, this

limitation is subject to the modification provided in that section.

* * * * * *

ART. 117–4. *Application of section 117 generally.*—Section 117 applies only to gains and losses upon the sale or exchange of capital assets and, therefore, has no application to loss of useful value upon the permanent abandonment of the use of property (see article 23 (e)–3), or loss sustained as the result of corporate stock or debts becoming worthless.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940

NO. 627.

GUY T. HELVERING, Commissioner of Internal Revenue, Petitioner,

v.

WILLIAM FLACCUS OAK LEATHER COMPANY, Respondent.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

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BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

William Flaccus Oak Leather Company, respondent above-named, through its attorney, prays that the petition heretofore filed herein for a writ of certiorari to review the judgment of the United States Circuit Court of Appeals for the Third Circuit, entered in the above-entitled cause on September 13, 1940, be denied.

OPINIONS BELOW.

The memorandum opinion of the Board of Tax Appeals (R. 5) is unreported. The opinion of the Circuit Court of Appeals (R. 17) is reported in 114 F. (2d) 783.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered September 13, 1940 (R. 23). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

Whether the gain arising from insurance payments for loss by fire of certain property, owned by the taxpayer, is a gain from the "sale or exchange" of a capital asset which may enter into the computation, under Section 117 (d) of the Revenue Act of 1934, of the deduction allowable for losses sustained by the taxpayer from sales or exchanges of other capital assets.

STATUTE AND REGULATIONS INVOLVED.

The relevant provisions of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 5-8.

STATEMENT.

The facts are correctly stated in the petition for certiorari, pages 2 to 4, inclusive.

REASONS FOR DENYING THE WRIT.

1. The decision below is only technically in conflict with the decision of the Court of Appeals of the District of Columbia in *Herder v. Helvering*, 106 F. (2d) 153. Here it was admitted that a fire loss and subsequent payment of a fire insurance policy thereon according to its terms do not constitute a sale or exchange apart from the applicable statutory definitions. But it was successfully contended that the Congress classified the

instant transaction as a sale or exchange. This point was not even mentioned in the *Herder* case.

In the presentation of the *Herder* case to the Court of Appeals of the District of Columbia, counsel for the taxpayer advanced a wrong reason for a right conclusion to this argument. The destruction of property and its compensation are not to be compared with the retirement of a bond, even though under local law this may have amounted to the payment of a liquidated claim. Congress specifically included the retirement of a bond as a sale or exchange thereof in Section 117(f) of the 1934 Act. This was after repeated Board cases had held such a transaction to be non-capital. *Douglas Fairbanks v. U. S.*, 306 U. S. 436. Observe, however, that although this is the view without a specific statute, the Congress specifically treats such retirement as a sale or exchange in Section 117(f) of the 1934 Act and subsequent Revenue Acts.

Counsel did not argue, in the *Herder* case, and, apparently, the Court did not consider, the proposition that the Congress classified a transaction like ours as a capital transaction (sale or exchange) in Section 112 and that we are bound by the classification. The only value of the *Herder* case is to remind us that Congress has now (1934 and subsequent Acts) classified retirement of bonds as a sale or exchange and this Court itself would now perforce decide the *Douglas Fairbanks* case exactly the opposite to its decision thereof under the 1926 and 1928 Acts. The Congressional classification is binding.

The full and only point here is that Congress has specifically classified destruction of property, and its compensation as a capital transaction treated as specifically provided in Section 112(f) rather than as in 112(a) of the Revenue Act of 1934 (Petitioner's Brief, pages 8 and 9). Out of the inclusiveness of Section

112(a), Section 112(f) has carved exceptions, including destruction (by fire or otherwise).

2. The cases of *Helvering v. Hammel,* No. 49 and *Electro-Chemical Engraving Co. Inc. v. Com.,* No. 62, October Term, 1940, cited in petitioner's brief (pages 4 and 5) as pending related questions, were both decided on January 6, 1941, and hold that a loss suffered from a foreclosure sale is a loss from a "sale" of a capital asset. Those decisions dispose of the case of *Com. v. Freihofer,* 102 F. (2d) 787 (C. C. A. 3), holding that a loss to the owner of land from foreclosure of a mortgage lien was not a loss from a "sale or exchange" under Section 117 of the Revenue Act of 1934.

3. The present cause is unimportant. The assets involved were used in taxpayer's business and were of a character subject to the allowance for depreciation. (Stip., par. 5, R. 4). Such depreciable assets are specifically excluded from classification as capital assets for 1938 and subsequent years. Revenue Act of 1938, Section 117(a); Internal Revenue Code, Section 117(a) (Appendix, *infra,* pp. 5-8). Thus the precise question here presented could not arise under the Revenue Act of 1938 or under subsequent revenue acts.

4. The decision of the Circuit Court of Appeals was correct, for the reasons stated in its opinion (R. 17-21).

CONCLUSION.

It is respectfully submitted that, for the foregoing reasons, the petition for certiorari should be denied.

JOHN A. MCCANN,
Attorney for Respondent.

January, 1941.

APPENDIX.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23. [U. S. C., Title 26, Sec. 21.]

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes * * * gains or profits and income derived from any source whatever. * * *

* * * * *

(e) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111. [U. S. C., Title 26, Sec. 22.]

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * *

[U. S. C., Title 26, Sec. 111.]

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange

of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

(1) *Property Held for Productive Use or Investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

(2) *Stock for Stock of Same Corporation.*— * * *

(3) *Stock for Stock on Reorganization.*— * * *

(4) *Same—Gain of Corporation.*— * * *

(5) *Transfer to Corporation Controlled by Transferor.*— * * *

(c) *Gain From Exchanges Not Solely in Kind.*—

* * * * *

(d) *Same—Gain of Corporation.*— * * *

* * * * *

(e) *Loss From Exchanges Not Solely in Kind.*— * * *

(f) *Involuntary Conversions.*—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or in the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of

the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

* * * * *

[U. S. C., Title 26, Sec. 112.]

SEC 117. CAPITAL GAINS AND LOSSES.

(a) *General Rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

* * * * *

(b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

(d) *Limitation on Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges.

* * * * *

(f) *Retirement of Bonds, etc.*—For the purposes of this title, amounts received by the holder

upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor. [U. S. C., Title 26, Sec. 101.]

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 117-1. *Meaning of capital assets.*—The term "capital assets" includes all classes of property not specifically excluded by section 117 (b). The term is not limited to stocks and bonds nor to property held for more than two years. In determining whether property is a "capital asset," the period for which held is immaterial.

ART. 117-2. *Limitations on capital gains and capital losses.*— * * *

Section 117 (d) provides a limitation on deductions for capital losses affecting all taxpayers including corporations, that is, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of $2,000 plus the gains from such sales and exchanges. However, in the case of certain banks or trust companies, this limitation is subject to the modification provided in that section.

* * * * * *

ART. 117-4. *Application of section 117 generally.*—Section 117 applies only to gains and losses upon the sale or exchange of capital assets and, therefore, has no application to loss of useful value upon the permanent abandonment of the use of property (see article 23 (e)-3), or loss sustained as the result of corporate stock or debts becoming worthless.

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GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, Petitioner,

v.

WILLIAM FLACCUS OAK LEATHER COMPANY.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENT.

JOHN A. McCANN,
Attorney for the Respondent.

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BRIEF FOR THE RESPONDENT.

OPINIONS BELOW.

The memorandum opinon of the Board of Tax Appeals (R. 8) is unreported. The opinion of the Circuit Court of Appeals (R. 19) is reported in 114 F. (2d) 783.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered September 13, 1940. (R. 22). The petition for a writ of certiorari was filed December 13, 1940, and was granted February 10, 1941. The jurisdiction of this Court is conferred by Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

Whether or not the gain arising in 1935 from compensatory insurance payments for loss by fire of capital assets, owned by the taxpayer, is to be classified as gain from a sale or exchange under Section 112(f) of the Revenue Act of 1934 and is to be used in the calculation of net capital gain or loss under Section 117(d) of that Act.

STATUTES AND REGULATIONS INVOLVED.

The relevant provisions of the statute and regulations are set forth in the Appendix, *infra*, p. 11 *et seq.*

STATEMENT.

The facts are correctly stated in the brief of the petitioner, pages 2 to 4, inclusive.

SUMMARY OF ARGUMENT.

In Section 111 of the Revenue Act of 1934, the Congress provided that the gain from a sale or exchange should be recognized to the extent provided in Section 112. Section 112(a) provided that the entire amount of such gain or loss should be recognized "except as hereinafter provided in this section". One of the series of exceptions to such ordinary treatment of the gains from sales or exchanges occurs in Section 112(f) in regard to involuntary conversions, including destruction of property in whole or in part. The rule laid down in Section 112(f) is, in part, that if the money received is expended for property like or similar in use to the destroyed propery (or is otherwise expended as stated in the subsection) no gain or loss is recognized; but if

the money received is not so expended, gain or loss is recognized but in an amount not in excess of such non-expended money. The exception in Section 112(f) is carved out of the general rule stated in Section 112(a), which relates solely to sales or exchanges. The instant transaction falls within Section 112(f). The gain from the involuntary conversion of the capital assets of this taxpayer is, therefore, classified in the Act as a gain from the sale or exchange of capital assets. Such gain is to be used in calculating net capital gain or loss as provided in Section 117(d).

ARGUMENT.

A. The Gain Derived by Respondent from Compensation Received By It on Account of a Loss of Capital Assets By Fire Constitutes Capital Gain, and Not Ordinary Gain.

The law applicable to this case is the Revenue Act of 1934. Pertinent portions thereof are printed in the appendix to this brief, pages 11 to 17.

Sections 111 and 112 of the Act deal with gain or loss on sale or exchange and with recognition of such gain or loss. Section 117 determines the amount of such gain or loss to be taken into account in computing taxable income, where the asset sold or exchanged was a capital asset.

It is not disputed that the factory and machinery of the instant taxpayer, which were destroyed by fire, were capital assets. Since, under Sections 111 and 112 of the Act, these capital assets can be said to have been sold or exchanged, Section 117 automatically comes into play. The only reason Section 117 is important in this case is that capital losses, on sale or exchange, are deductible only to the extent of $2,000 more than the gains.

This taxpayer sold other capital assets at a loss of more than $2,000 in excess of the gain derived by it from the transaction at issue in this case. This may be illustrated as follows:

Taxpayer's Treatment of Capital Gains and Losses:

Capital Losses (other sales)		$76,767.62
Less: Capital Gains:		
Instant transaction	$73,132.50	
Other sales not in issue	862.50	73,995.00
Excess of Losses over Gains		$ 2,772.62
Loss allowable (Sec. 117)		2,000.00
Loss not allowable		$ 772.62

Net result of above transactions on income:
Loss—$2,000.00

Commissioner's Treatment of the Same Items:

Capital Losses	$76,767.62
Less: Capital Gains	862.50
Excess of Losses over Gains	$75,905.12
Loss allowable	$ 2,000.00
Add: Ordinary income from the instant transaction	73,995.00
Total Income from all of above transactions	$71,995.00

Section 117 applies in a purely mathematical calculation of the gain or loss. The real issue here is the meaning of Section 112(f) of the law.

Since Section 112(f) is one of the exceptions carved out of 112(a), its subject matter must have been within the totality of 112(a), which deals only with sales or exchanges.

But the taxpayer does not have to rely upon such formal reasoning without regard to realistic considerations. The latter are also in the taxpayer's favor. From a practical standpoint, a taxpayer whose building has burned down, and who has received insurance money to compensate him for the loss, is in no different position than one who has sold his building and received the cash purchase price. Any gain in the latter transaction is clearly a capital gain from sale or exchange (under the above 1934 Act). To treat them the same is entirely uniform, logical, equitable, and in harmony with the system of internal revenue taxation. The difference is the element of personal volition.

There was no element of personal volition, meeting of the minds, or contractual agreement, in *Helvering v. Hammel*, No. 49, October Term, 1940, or in *Electro-Chemical Engraving Co., Inc. v. Commissioner*, No. 62, October Term, 1940, both decided by this Court on January 6, 1941, and both arising under the Revenue Act of 1934. In both cases, the Court held that a debtor's loss on a foreclosure (a sale *in invitum*) was to be treated as a loss on sale or exchange. In the *Hammel* case, the element of personal volition was discussed and determined to be unnecessary. Similarly, this Court held, in *McClain v. Commissioner*, ... U. S. ...., decided January 6, 1941, that a loss on retirement of bonds under Section 117(d) of the 1934 Act, includes a loss on forced surrender of such bonds for a nominal sum as well as a loss on voluntary surrender or redemption. The Board of Tax Appeals, in *Hawaiian Gas Products, Ltd.*, 43 B. T. A. .... (Advance Sheets, No. 91, Promul-

gated Feb. 18, 1941) has just followed that theory in holding that a loss sustained by a taxpayer through the condemnation and taking of his property by the Territory of Hawaii under its power of eminent domain was to be treated as a loss on sale or exchange under the Revenue Act of 1936, containing provisions identical with those of the Revenue Act of 1934 in this regard. It was found as a fact by the Board that the gas company filed an answer in the condemnation proceeding, stating that it did not wish to sell but recognized the Territory's power of eminent domain. It does not appear that the gas company reinvested the funds.

Neither did the instant taxpayer reinvest the funds. The petitioner says that the taxpayer could not sell or exchange what had ceased to exist. (Petitioner's Brief, page 5). But neither could the Hawaiian company sell or exchange what had been seized by the local government. Both cases fall within Sections 112(f) and 117(d).

In *Pelican Bay Lumber Co. v. Blair*, 31 F.(2d) 15 (C. C. A. 9), cert. den. 49 S. Ct. 512, the Ninth Circuit characterizes the receipt of insurance proceeds not reinvested as follows:

> "In other words, the transaction would in effect have amounted to a sale of property costing $98,202.83 at a profit of $67,917.49."

Petitioner has recognized the receipt of insurance proceeds as involving capital net gain under Section 117. In Regulation 86, Article 113 (a) (9),—*infra*, Appendix, p. 16,—petitioner proposes the illustration of receipt in 1934 of $200,000 of insurance upon destruction of a vessel purchased in 1926 for $100,000, and reinvestment of $150,000 of the insurance in a new vessel. Disregarding depreciation adjustments, the example says thereof:

> "* * * a taxable gain to the extent of $50,000 would be recognized. *As to the amount of such gain to be taken into account in computing net income, see Section 117.*" (Italics Supplied)

Section 112(f) provides not only for cases where there has been a partial replacement but also for cases where there has been no replacement, by like or similar property. Excerpts from the section show this to be true. The hypothetical "if" clause, reads in part: "If property (as a result of its destruction in whole or in part * * *) is * * * involuntarily converted * * * into money * * * which is forthwith in good faith * * * expended [for replacement, acquisition of control of a "replacement" corporation, or establishment of a replacement fund] no gain or loss shall be recognized". To this point, replacement of some kind is necessary. But the section continues: "If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended". In our case, in a very realistic sense, the property was converted into money. No part of the money was reinvested. Therefore, the gain is recognized as provided in Section 112(a).

B. An Argument Like This One, Based on Section 112, Was Not Made, Mentioned, or Considered in the Herder Case.

As noted by the Court below (R. 21) in our case, the conclusion reached by it is contrary to that reached in *Herder v. Helvering*, 106 F.(2d) 153 (C. of A., D. of C.), cert, den., 308 U. S. 617. The Third Circuit noted (R. 21) that it did not appear from the opinion that the ground on which the decision rests in this case was presented to that court. This is true. We have ex-

amined the records and briefs in the Herder case and they contain no argument of this kind.

Petitioner's counsel argued in the Herder case that the surrender of an insurance policy was similar to the retirement of a bond since the payment of the $50,000 of insurance money in that case was "only incidentally according to the terms of the insurance policies, and" was "in fact a payment of a liquidated claim arising upon the occurrence of the total loss by fire". Thus, they argued, the payment was on the registered policy, transformed into a liquidated demand by destruction of the insured property, and bearing interest until paid. It was further argued that such a payment fell within the provisions of Section 117(f) as a payment on a registered evidence of indebtedness issued by a corporation and bearing interest.

C. Criticism of the Argument of the Petitioner.

First. The argument (Petitioner's Brief, pages 9-10) that Section 112 deals merely with replacement of property must fall because it deals specifically with "sales or Exchanges". Section 112(a) reads:

> "General Rule.—On the sale or exchange of property the entire amount of the gain or loss, determined under Section 111, shall be recognized, except as hereinafter provided in this section".

Property may be converted (1) into other property, (2) into other property and money, or into (3) money. Each is a conversion. The fact that the conversion is involuntary and of property into money is immaterial. That is true of sales aside from the element of voluntary action of the prior owner. The situation presented in the *Hammel* case, *supra,* was an involuntary conversion. There was no replacement. The money was re-

ceived on the mortgage. The mortgage was later foreclosed without the will of the mortgagor.

Second. Petitioner's argument (pages 15 to 20) based on the history of the section is also without substance. He argues that since the original predecessor section (R. A. 1921, Section 234(a)(14)) was a deduction section, applicable only in case of gain and on a partial exchange, the new substituted section (R. A. 1924, Section 203(b)(5)) should be limited to replacement, or to partial replacement, situations. This argument fails to give effect to the entirely new scheme of the Revenue Act of 1924, and subsequent Acts, which for the first time had a separate section on recognition of gain or loss. If Congress had desired to retain the old deduction provision it would have done so under Section 23 or a similar section. The language in regard to involuntary conversions was changed and they were filled into the scheme not only of "exchanges" but of "sales or exchanges". If the property was replaced in whole or in part, the transaction was treated as an exchange. In that event, counsel for the government would admit that the gain, if any, was taxable as capital gain under 112(f) and 117(d). But if the money obtained was not used for replacement, then the gain was still recognized, this time as on a sale rather than an exchange, and the same capital system of computation was applied.

Third. Any consistency in policy of the Treasury Department in prior regulations (Petitioner's Brief, pages 20-21) loses force in view of Article 113(a)(9)(1) of Regulations 86 under the 1934 Act (Appendix to this brief, p. 16). It also loses force in view of the specific wording of the statute which requires no classification by regulations.

Moreover, there has been no rounded consistency in the treatment of gains and losses. For example, a gain on the sale of a personal residence is taxable as capital gain, but a loss thereon is not deductible as a capital loss or otherwise.

CONCLUSION.

1. The gain from the involuntary conversion of taxpayer's capital assets into cash is to be recognized as provided in Section 112 (f) of the Revenue Act of 1934 and is to be included in income as provided in Section 117(d) of the Revenue Act of 1934.

2. The decision of the Court below is correct and it should be affirmed.

Respectfully submitted,

JOHN A. MCCANN,
Attorney for the Respondent.

March, 1941.

APPENDIX.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23. [U. S. C., Title 26, Sec. 21.]

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes * * * gains or profits and income derived from any source whatever. * * *

* * * * *

(e) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111. [U. S. C., Title 26, Sec. 22.]

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(e) LOSSES BY INDIVIDUALS.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

* * * * *

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

(f) LOSSES BY CORPORATIONS.—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

(j) CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117 (d).

* * * * *

[U. S. C., Title 26, Sec. 23.]

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * *

[U. S. C., Title 26, Sec. 111.]

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

(f) *Involuntary Conversion.*—If property (as a result of its destruction in whole or in part, theft

or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

* * * * *

[U. S. C., Title 26, Sec. 112.]

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a). BASIS (UNADJUSTED) OF PROPERTY.—The basis of property shall be the cost of such property; except that—

* * * * *

(9) INVOLUNTARY CONVERSIONS. If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion described in section 112 (f), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer

recognized upon such conversion under the law applicable to the year in which such conversion was made.

* * * * *

[U. S. C., Title 26, Sec. 113.]

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *General Rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income: * * *

(b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(c) DETERMINATION OF PERIOD FOR WHICH HELD.— * * *

(d) LIMITATION ON CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, sells any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof), with interest

coupons or in registered form, any loss resulting from such sale (except such portion of the loss as does not exceed the amount, if any, by which the adjusted basis of such instrument exceeds the par or face value thereof) shall not be subject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses.

(e) GAINS AND LOSSES FROM SHORT SALES, ETC.— * * *

(f) RETIREMENT OF BONDS, ETC.—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor. [U. S. C., Title 26, Sec. 101.]

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 112 (f)–1. *Reinvestment of proceeds of involuntary conversion.*—In order to avail himself of the benefits of section 112 (f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. The benefits of section 112 (f) cannot be extended to a taxpayer who does not purchase other

property similar or related in service or use, notwithstanding the fact that there was no other such property available for purchase.

* * * * * *

It is incumbent upon a taxpayer "forthwith" to apply for and receive permission to establish a replacement fund in every case where it is not possible to replace immediately. If an expenditure in actual replacement would be too late, a request for the establishment of a replacement fund would likewise be too late.

* * * * *

ART. 113 (a) (9)–1. *Property acquired as a result of an involuntary conversion.*—The provisions of section 113 (a) (9) may be illustrated by the following example:

Example: A vessel purchased by A in 1926 for $100,000 is destroyed in 1934 and A receives insurance in the amount of $200,000. Disregarding, for the purpose of this example, the adjustment for depreciation, if A invests $150,000 in a new vessel, taxable gain to the extent of $50,000 would be recognized. As to the amount of such gain to be taken into account in computing net income, see section 117. The basis of the new vessel is $100,000; that is, the cost of the old vessel ($100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel ($50,000) plus the amount of gain recognized upon the conversion ($50,000).

ART. 117–1. *Meaning of capital assets.*—The term "capital assets" includes all classes of property not specifically excluded by section 117 (b). The term is not limited to stocks and bonds nor to property held for more than two years. In determining whether property is a "capital asset," the period for which held is immaterial.

ART. 117–2. *Limitations on capital gains and capital losses.*—* * *

Section 117 (d) provides a limitation an deductions for capital losses affecting all taxpayers including corporations, that is, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of $2,000 plus the gains from such sales and exchanges. However, in the case of certain banks or trust companies, this limitation is subject to the modification provided in that section.

* * * * * *

ART. 117–4. *Application of section 117 generally.*—Section 117 applies only to gains and losses upon the sale or exchange of capital assets and, therefore, has no application to loss of useful value upon the permanent abandonment of the use of property (see article 23 (e)–3), or loss sustained as the result of corporate stock or debts becoming worthless.

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SUPREME COURT OF THE UNITED STATES.

No. 627.—October Term, 1940.

Guy T. Helvering, Petitioner, *vs.* William Flaccus Oak Leather Co., Respondent.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

[April 28, 1941.]

Mr. Justice Murphy delivered the opinion of the Court.

In September, 1935, respondent's plant was destroyed by fire. Later that year it received $73,132.50 from an insurance company as compensation for the loss of buildings, machinery, and equipment. The buildings, machinery, and equipment had been fully depreciated for income tax purposes prior to 1935, and no part of the insurance proceeds was used to acquire other property similar or related in service or use to the property destroyed, or to acquire control of a corporation owning such property, or to establish a fund to replace the property destroyed.

In its return for 1935, respondent reported the insurance proceeds as capital gain and added to that amount a gain, not in issue here, of $862.50 from sales of securities. During that same year, respondent had capital losses, also not in dispute, of $76,767.62 which it used to offset completely the total reported capital gains of $73,995. This left an excess of capital losses over capital gains of $2,772.62, and respondent deducted $2,000 of that amount from ordinary income.

The Commissioner held that the insurance proceeds were ordinary income rather than capital gain. Accordingly, he decreased respondent's capital gain and increased its ordinary income by $73,132.50, and allowed respondent capital losses of only $2,862.50, an amount equal to the gain from security sales plus $2,000. The Board of Tax Appeals affirmed in a memorandum opinion on the authority of *Estate of Herder*, 36 B. T. A. 934. The Circuit Court of Appeals reversed. 114 F. (2d) 783. We granted certiorari on February 10, 1941, because the decision below was in conflict with *Herder* v. *Helvering*, 106 F. (2d) 153.

It is conceded that respondent's losses resulted from sales or exchanges of capital assets. It is also conceded that the entire amount received from the insurance company must be included in respondent's income since the property had been fully depreciated for income tax purposes prior to 1935. Respondent contends, however, that that amount may be reported as capital gain, in order that capital losses may absorb it, rather than as an item of ordinary gross income.

Section 117(d) of the Revenue Act of 1934 (48 Stat. 680) provides in part: "Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges." Thus, the single question is whether the amount respondent received from the insurance company derived from the "sale or exchange" of a capital asset.

Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words "sale" and "exchange" are not to be read any differently. Compare *Helvering* v. *Hammel,* 311 U. S. 504; *Fairbanks* v. *United States,* 306 U. S. 436; *Burnet* v. *Harmel,* 287 U. S. 103. Neither term is appropriate to characterize the demolition of property and subsequent compensation for its loss by an insurance company. Plainly that pair of events was not a sale. Nor can they be regarded as an exchange, for "exchange", as used in § 117(d), implies reciprocal transfers of capital assets, not a single transfer to compensate for the destruction of the transferee's asset.

The fact that § 112(f) characterizes destruction of property and indemnification for its loss as an involuntary conversion does not establish that the two events constituted a sale or exchange. That section provides: "If property (as a result of its destruction in whole or in part, theft, seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recog-

nized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended."

We can find nothing in this language or in other sections of the Act which indicates, either expressly or by implication, that Congress intended to classify as "sales or exchanges" the involuntary conversions enumerated in § 112(f). It is true that § 111(c) says that "in the case of a sale or exchange, the extent to which the gain or loss . . . shall be recognized . . . shall be determined under the provisions of section 112". It is also true that § 112(f) follows § 112(a) which provides that "upon the sale or exchange of property the entire amount of the gain or loss . . . shall be recognized except as hereinafter provided in this section".

The inference, drawn from the juxtaposition and cross referencing of these three sections, that the involuntary conversion of respondent's property is thus implicitly characterized as a sale or exchange ignores the fact that in the same Act Congress has chosen a particular method for classifying as sales or exchanges transactions which would not ordinarily be described by one of those terms. Thus § 115(c) provides: "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock."

Section 117(e) provides: "For the purposes of this title gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets; and gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as gains or losses from sales or exchanges of capital assets held for one year or less." See H. Rep. No. 704, 73d Cong., 2d Sess., p. 31; H. Rep. No. 1385, 73d Cong., 2d Sess., p. 23. Section 117(f) provides: "For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes or certificates or other evidences of indebtedness issued by any corporation . . . with interest coupons or in registered form, shall be considered as amounts received in exchange therefor." See *McClain* v. *Commissioner*, 311 U. S. 527; *Fairbanks* v. *United States, supra;* H. Rep. No. 704, 73d Cong., 2d Sess., p. 31.

These sections demonstrate that Congress has expressly specified the ambiguous transactions which are to be regarded as sales or exchanges for income tax purposes. They are convincing evidence that the involuntary conversion of respondent's property, which bears far less resemblance to a sale or exchange than the transactions embraced in §§ 115(c), 117(e), and 117(f) is not to be placed in one or the other of those categories by implication. The prompt withdrawal of Article 113(a)(9)(1) of Treasury Regulations No. 86 (see T. D. 4098, XV-2 Cum. Bull. 159) indicates that the administrators charged with the enforcement of § 112(f) reached a similar conclusion. Compare *Burnet* v. *Chicago Portrait Co.*, 285 U. S. 1, 16.

The judgment of the Circuit Court of Appeals is reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.